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THE NONBANK BANK CONTROVERSY CONTINUES

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One of the most controversial aspects of the financial deregulation process is the mounting trend towards the formation of nonbank banks. Basically, a nonbank bank is an institution that, in order to avoid federal regulation under the Bank Holding Company Act of 1956, offers either demand deposits or commercial loans but not both. Nonbank banks are the subject of Congressional debate, court litigation, actions by state legislatures, debates among bankers, and discussion by federal and state bank regulators. This special status of nonbank banks has been exploited by bank holding companies, which want to use them as a vehicle to cross state lines, and by other organizations, such as brokerage houses and retail chains, which want to open up their own banking subsidiaries. As a result, nonbank banks are the center of a controversy that divides the financial community and draws conflicting responses from the federal banking regulators.

The Nonbank Bank

Many of the services that banks traditionally offer are now provided by other financial and nonfinancial firms. Merrill Lynch has a Cash Management Account while Sears Roebuck has Financial Centers in their retail stores. Thus, nonbanking firms have pushed into the realm of traditional banking activities, but without coming under banking regulation, by taking advantage of an apparent loophole in the Bank Holding Company Act (BHCA). According to the BHCA, if a firm owns a bank, which is defined as "any institution. . . which (1) accepts deposits that the depositor has a legal right to withdraw on demand, and (2) engages in the business of making commercial loans," then the firm is a bank holding company and therefore subject to the regulations associated with the Act. Consequently, nonfinancial firms have sought to avoid becoming bank holding companies by establishing nonbank banks which fail to satisfy the legal definition of a bank.

By eluding bank holding company status, these nonfinancial firms keep clear of the requirement to divest themselves of all business activities not permitted to bank holding companies under the BHCA, such as manufacturing, retailing or insurance brokerage. In effect, nonfinancial firms can own nonbank banks, which are chartered by bank regulators, can be members of the Federal Reserve System, and can obtain federal deposit insurance (FDIC). Nonbank banks are also subject to capital and reserve minimums, examinations and other requirements much like those imposed on full-service banks. It is not the nonbank banks that are unregulated; it is their parent organizations that are able to enjoy more freedom than the owners of traditional banks.

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Bank holding companies have perceived advantages to exploiting this loophole as well. Over 50 bank holding companies have applied for charters to open nonbank banks in numerous states. Because a nonbank bank is not considered legally to be a bank subsidiary, bank holding companies can use them as a vehicle to sidestep the Douglas Amendment of the BHCA, which prohibits a bank holding company from acquiring a bank in another state unless that state legislature specifically permits the acquisition. That is, bank holding companies can set up nonbank bank subsidiaries in other states without obtaining the state's permission, and engage to a limited degree in interstate banking.

Thus, not only can anyone acquire a nonbank bank but one can do so anywhere, thereby breaching the law's geographical restrictions as well. Today, there are over 200 nonbank banks in operation, owned by diverse companies including American Express, John Hancock Mutual Life Insurance Company and Ford Motor Company. Most of the holding companies that have established nonbank banks have employed them to provide a limited service (also called limited-service banks or consumer banks). Gulf & Western, one of the first companies to acquire a limited-service bank, uses its nonbank bank to support its credit card and consumer lending operations. Merrill Lynch started a nonbank bank so that it could process its cash management account customers' check and credit card transactions in-house, and offer its own insured deposits to money-market fund customers. Dreyfus Corporation pushed into banking to apply its mass-marketing techniques to the solicitation of consumer deposits and to offer mortgage and auto loans. And, Sears Roebuck uses its consumer bank (Sears Savings Bank) as part of its consumer financial services package.

The Signs of Change

One of the driving forces behind the nonbank bank movement is reflected in recent Federal Reserve Board data which reveals that banks are losing many of their commercial loan customers. In the 1950s, banks supplied 85 percent of U.S. corporations' short and intermediate term credit, they now provide only 60 percent of such credit, and the downward trend seems to be continuing. Most dramatic has been the drop in commercial and industrial lending, which is estimated to have slipped from 43 percent in 1974 to 27 percent today. Banks are unable to make up those losses in the consumer markets as they are no longer the primary source of individuals' credit. In 1985, finance companies, credit unions, retailers and savings institutions held 56 percent of all consumer debt; banks held 44 percent, down from 48 percent in 1980.

Clearly, companies outside the banking industry are increasingly diversifying and branching out into financial services. Ford Motor Company and General Motors operate finance subsidiaries that are no longer interested in merely extending auto loans. Both firms' subsidiaries are now heavily involved in mortgage banking. General Electric Corporation has become a major business lender, and with its recent acquisition of Kidder Peabody & Company, is now becoming a major investment banker.

What accounts for these changes? First, the highly volatile period of the 1970s and the early 1980s caused many different kinds of institutions to

develop and market innovative financial products designed to achieve a greater return on their savings and investment. During that period, double-digit inflation pushed interest rates on government securities far above the interest rates the banks and thrifts were then limited by law to pay their depositors. Soon after, the money market fund industry exploded, drawing billions of dollars away from bank deposits. NOW accounts offered by thrifts in certain states had the same effect. Although Congress subsequently removed the interest rate ceilings on bank deposits, both thrift institutions and money market funds (and the securities companies that have sponsored the funds), have continued to be strong competitors to banks in providing transaction services. These events created additional demand for nonbanking financial services from bank customers, thereby generating an opportunity for new suppliers of financial services to enter markets in which they had not been able to compete previously.

Deregulation of interest rates bought on by the Depository Institutions Deregulation and Monetary Control Act of 1980 opened up a new era in price competition by phasing out Regulation Q ceilings, and thus facilitated nonbank bank competition in lending activities. Banks now had to pay more for their funds and had to increase the interest rates charged on loans. This situation narrowed their competitive advantage over lenders who rely on uninsured debt and equity to fund their activities, but who also do not incur the costs of reserve requirements, deposit insurance premiums and regulatory compliance that banks must bear.

In the early 1980s, the banking industry was also reeling from the steepest recession of the post World War II period. If this were not enough, this was followed by an international debt crisis; a period of disinflation that undermined the value of tangible assets such as real estate and commodities; and an oil glut. Two of those, agriculture and energy, are causing particular concern in the banking industry because of their regional concentration. Banks claim that they are inhibited by branching restrictions from adequately diversifying their loan portfolios and are thus exposed to devastating losses.

Furthermore, the booming securities markets of the 1980s have encouraged an increasing number of firms to raise funds through the capital markets rather than borrow from banks. In 1979, new securities (excluding commercial paper) offered by corporations totaled $52 billion and represented just 18 percent of the $291 billion in commercial loans held by banks. But by 1985 the volume of corporate securities issued, $156 billion, had soared to 31 percent of all end-of-year bank commercial loans ($496 billion).

In addition, quantum advances in telecommunications and computer technology now permit the rapid and low-cost transfer of funds and information worldwide. These advances are playing a significant role in eliminating political boundaries as barriers to the flow of financial capital. And, state restrictions are even becoming increasingly ineffective as more and more consumers are able to use nationwide computer networks to shop for and obtain banking services. Consequently, depository institutions are shunning traditional methods of offering financial services. For example, Greenwood Trust Company, the consumer bank owned by Sears, solicits deposits nationwide,

promising savers higher returns and lower costs because of the absence of a physical branch network. Financial services firms that hope to survive and prosper in this rapidly changing environment will need to exhibit more flexibility than was required in previous decades. Nonbank banks represent an attempt by many firms to attain such flexibility.

Should the Loophole be Closed?

In today's financial reform debate, there are several arguments being advanced as favoring the imposition of new controls over the activities of nonbank banks. First, nonbank bank opponents claim that the banking system is an important element in the transmission of monetary policy, and nonbank banks undermine that function. However, those in favor of the nonbank bank claim that the issue concerns ownership and affiliations of financial institutions, not essential elements of monetary policy. The Monetary Control Act of 1980 requires that nonbank banks issuing demand deposits must be subject to reserve requirements. Although their parent companies may differ, the monetary status of banks and nonbank banks is the same under the Monetary Control Act.

Another argument concerns the impact of nonbank banks on safety and soundness of the banking and financial system--an issue which arises because depository institutions are custodians of a significant portion of the nation's wealth and payments system. The public interest requires the government to establish a protective safety net and to monitor the system. Thus, the essential issue for nonbank banks affiliated with other enterprises is whether they increase the overall riskiness of the financial system. Some would argue that such institutions are less risky than commercial banks since nonbank banks operating in the consumer market may have relatively low risk highly liquid assets generating a constant cash flow. They are not subject to sharp fluctuations in market value and may be more liquid than the consumer portfolio.

Another often heard objection is that a nonbank bank might be forced to lend to its parent or another subsidiary at preferential interest rates and without the appropriate credit quality controls. Should such a loan go bad, it could endanger the bank. On a related matter, there is also the concern that if the nonfinancial parent becomes bankrupt, regulators' fears that its failure will undermine the stability of the banking subsidiary and force them to bail out the parent, its creditors and other subsidiaries. Given that depository institutions and their insurers are already facing difficulties, the contingent liabilities that might arise from expanded ownership of banks could create further problems.

Nonbank bank opponents also argue that the deposits these nonbanks collect are not likely to remain in the same community. But nonbank bank owners claim that they usually are willing to offer higher interest rates on deposits, a wider range of services, and possibly even lower interest rates on loans--enticements that will threaten the ability of locally based institutions to compete. Once the local banks are pushed out by these competitive pressures, it is argued, service to consumers will suffer because the owners of nonbank banks will divert their attention and resources toward the more lucrative markets. Nonbank bank proponents claim that these

objections are often raised by the owners of depository institutions in areas where new bank entry has been limited and local markets are protected by restrictive branching laws. In effect, the presence of nonbank banks will erode the barriers to interstate banking and enhance competition.

Thus, at the heart of this debate is the issue which led to the prohibition of interstate banking in the first place--will the authorization of interstate banking lead to increased concentration and decreased competition in banking? Many trade associations, such as the Independent Bankers Association of America, believe that greater concentration of financial resources at the national level will result and are thus opposed to interstate banking and nonbank banks. However, others contend that it is important to recognize that increased national concentration does not necessarily imply reduced competition at the local market level. Indeed, the elimination of geographical barriers to entry should result in more competition, greater efficiency, and more diversified services in the market.

Nonbank bank opponents also complain of the additional powers that can be exercised by the parent companies and affiliated subsidiaries. They argue that banks should be distinguished from other financial and nonfinancial providers, and that the government, through the regulatory agencies, should assure their safety and soundness. Many of these opponents also fear that product deregulation would permit large bank holding companies and other financial conglomerates to accumulate too much economic and political power.

In addition, nonbank bank opponents claim that because banks possess advantages such as entry restrictions, deposit insurance and access to the Federal Reserve Board's discount window, they would have a competitive advantage over other suppliers of financial services unless reciprocal entry is allowed. Federal Reserve Board Chairman Paul Volcker has maintained that continuing to allow nonbank banks to operate would be indicative of a failure to "respect the uniqueness of banking."

Nonbank bank opponents also maintain that the lack of regulation of nonbank banks' parent companies could cause tie-in sales to result. Those who oppose insurance, securities and retailing firms' ability to purchase banks speculate that customers of those highly diversified firms will be coerced into buying goods and services at higher prices. That is, they envision a consumer loan being approved only if the customer agrees to buy his life insurance or draperies from the insurance or retailing subsidiary of the holding company.

Many deregulation advocates argue that such potential problems can be eliminated through laws and regulations restricting or prohibiting tie-in sales, intracorporate and affiliate lending, and federally sponsored financial aid to the parent firm and other subsidiaries of a holding company that includes a bank. Nonbank bank proponents argue that the problem with nonbank banks lies not in who can own a bank, but in the fact that traditional bank holding companies are prohibited from responding to the competitive challenges that result from a constantly changing environment. The competitive pressure on banks is heightened when nonbank financial firms can offer close substitutes to banking services, while banks are prevented from responding with their own innovative products.

Clash of the Regulators

Nonbank banks are a major point of contention between the bank regulatory agencies, especially between the Federal Reserve Board and the Comptroller of the Currency. After years of delays and warnings to Congress, the Comptroller decided in October 1984 that he had no power to stop nonbank banks and began chartering new ones. The Treasury clearly favors faster deregulation of the financial marketplace, while the Federal Reserve Board wants to move with greater caution to insure safety and soundness of the banking system. About 280 applications to open nonbank banks in 38 states are awaiting approval by the Comptroller. In addition to receiving chartering authority from the Comptroller, these institutions must also receive Federal Reserve authority to acquire nonbank banks. The Federal Reserve essentially opposes nonbank banks because it believes proliferation of the organizations will undermine the BHCA restrictions on interstate banking and the separation of banking and commerce.

In addition to regulators' conflicts, legal battles have also blocked approval of nonbank banks. Recently, the Supreme Court allowed a New York-based holding company, U.S. Trust Corporation, to establish a subsidiary to run a nonbank bank in Palm Beach, Florida. Earlier this year, a U.S. Court of Appeals in Atlanta ruled that it was legal for a bank holding company to expand its consumer deposit-taking operations across state lines by means of a limited-service bank.

Congressional Response

Concern over the nonbank bank issue has generated much of the financial reform interest in Congress, including several legislative proposals to address the issue by imposing restrictions on nonbank banks. Indeed, the closing of the loophole has become the top priority of both the House and Senate banking committees this year.

Many trade associations such as the American Bankers Association, the Independent Bankers Association, the National Council of State Legislators, the Conference of State Bank Supervisors, the National Association of Home Builders, the National Federation of Independent Business, and the U.S. League of Savings Institutions support the closing of the nonbank bank loophole. While members of Congress have promised to halt the proliferation of these loophole banks, interest in setting up interstate networks of nonbank banks appears to be growing rather than diminishing. Included among the supporters of nonbank banks are the American Financial Services Association, the Association of Bank Holding Companies, the Consumer Bankers Association, the National Council of Savings Institutions, the American Retail Federation and the Dealer Bank Association. In addition, the Reagan Administration has openly endorsed nonbank banks, claiming that increased competition would benefit consumers.

On March 27, the Senate approved a comprehensive banking bill (The Competitive Equality Banking Act of 1987), that would essentially recapitalize the ailing Federal Savings and Loan Insurance Corporation (FSLIC), prohibit the establishment of new nonbank banks, and place a moratorium on expanded powers for banks. The bill (S. 790) closes the nonbank bank loophole by redefining a bank as an institution insured by the Federal Deposit Insurance Corporation, regardless of whether it accepts demand deposits or makes

commercial loans. All nonbank banks operating as of March 5, 1987 would be allowed to operate for one year (this applies to 166 nonbank banks), but these institutions could not commence any new activities. After the one year moratorium expires, a 7 percent annual limit would be placed on their rate of growth. The bill also places some limits on the ability of nonbank banks to cross-market products and services among affiliates. The moratorium provisions in the Senate bill recently prompted the House Energy and Commerce Committee Chairman Dingell (D-MI) to ask the House leadership to refer S. 790 to his committee for consideration.

House Banking Chairman St. Germain (D-RI) will not consider the broad banking legislation passed by the Senate, but instead will only introduce single purpose bills. Recently, the House Banking Committee approved H.R. 27, a bill that would raise $5 billion through the borrowings in the capital markets for the insolvent FSLIC over a two-year period. Separately, the House approved legislation that would limit the time that financial institutions may hold deposited checks before making the funds available.

Prospects for enactment of major financial legislation are clouded by a number of factors, namely, the increasing inability of both the financial industry and members of Congress to reach a consensus on policy questions underlying the debate on financial reform. In addition, the Federal Reserve Board's recent decision to allow three major bank holding companies (Bankers Trust New York Corporation, Citicorp and J.P. Morgan & Company) limited authority to underwrite certain securities through subsidiaries, further blurs the legal line separating commercial and investment banking. However, the bank holding companies' ability to exercise their new powers could be delayed by legislation being considered by Congress. But since Congress has been unable to resolve financial issues in the past few years, much of the impetus for financial reform has been provided by state legislatures, federal regulators and the courts, and the same is occurring in 1987.